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THE SET-UPS OR THE BIG PICTURE

> Trading is easy. Only buy stocks that are going up. If they don't go up, then don't buy them.
>
> —Will Rogers

This chapter covers the *set-ups* for profitable trading—looking at the big picture to determine where the market is in its overall development. After this, technical tools are used to pick exact entry techniques, stop loss protection in the event you are wrong, and likely targets for the move. Just as is true for real estate, the most important factor in trading is location, location, location. In addition, add timing, timing, and timing. The set-up gives you an overall picture on where the market is in its stage of development—a key factor when looking at short-term reversal and continuation patterns. Ideally, you enter the market in the zone that has the greatest probability of being a successful trade. Expressed another way: Go long in the buy or support zones and short or take profits in the sell or resistance zones. Ideas such as accumulation, distribution, buy zones, and sell zones will be explained in this chapter.

TRADING VERSUS INVESTING

The first step in investing is to study the basic market fundamentals. Economic factors may take a number of years to be reflected in the market so a longer term view is important. However, trading involves a study of the technical factors that govern short-term market movements as well as the psychological makeup of the buyers and sellers in the market. Trading involves more risk than long-term investing, but it also offers opportunity for greater profits.

THE ULTIMATE TIMING TOOL FOR ALL MARKETS

Short-term trades that have gone sour or ones that I failed to get out of become my long-term investments. You may have heard the expression: "You know it has to go back up." Let me assure you that the market does not have to do anything. If I had to tell you the exact time and price that the market will turn back up, it would be when I abandon the trade and not one minute before. Learn this market principle well because it will save you many dollars. This principle has, in fact, made me many dollars. I have had investors call me hoping for some assurance that the particular market they are in will turn back up. My response is always the same, "Let me know when you liquidate because that is the time I will buy." If a trade is not acting right, get out. Don't stay with a position. Your capital will remain intact for another trade. Learn to love small losses.

TECHNOLOGY REVOLUTION

We occasionally hear people say: "Markets have changed since the technology revolution" or "If I get enough expensive software and computers tracking all these indicators, surely I can make money in these markets." Markets have always behaved in the same manner because human nature is constant. The same forces are still at work: fear and greed and supply and demand. Markets go through cycles. Nothing has changed. Two equity charts, one from today and one from 1950 with the prices removed would have similar characteristics. Markets in 1950 were just as volatile on a percentage basis as they are today.

The technology revolution has not made a difference in trading except execution cost and ease of order placement. Although information is available more rapidly, traders' win/ loss ratio remains at around 80% losers/20% winners. One important big difference is the execution cost and ease of order placement. The execution cost can make a big difference in the bottom line. Ease of execution may actually hurt your bottom line. Having fast computers, expensive software, or working with the latest hot techniques such as "chaos" or "space age technology" will not necessarily add to your bottom line.

Many indicators that massage market data come up with indexes providing essentially the same information. They tell you the extent of an overbought/oversold situation. Indicators are usually lagging, thus, you enter the market late and exit late—a losing situation. Learn to read the forces at work by studying the charts and chart patterns.

The technology revolution has put a damper on the "Rainbow Merchants" who promise instant riches if you follow their formulas. The average stock owner now has the capability of checking the formulas with inexpensive software such as Omega®. However, the promise of instant wealth lures even the best of us. The Holy Grail simply does not exist. If it did someone would have taken all the “chips” and we would no longer have markets. You can achieve a technical edge by studying the charts, but you must deal with your own psychological makeup. Some people could not make money if you gave them next week’s *Wall Street Journal*. Know who you are.

A successful trader must have knowledge. However, having knowledge does not automatically make you a successful trader. There is a giant chasm between knowledge and a successful trader. Few of us are able to make that leap and those that do must be on the alert or they will fall back into the abyss. One of the authors has been up and down the investment mountain so many times he has lost count. The last time he came down he made a promise that if he ever got even half way back up the mountain he was not coming back down. Incidentally, if enough of you buy this book, it will take that author out of the valley.

Money buys us freedom, nothing more and nothing less. Once you achieve a certain level of wealth, collecting additional “things” does not add to your happiness or give added freedom. If you collect too many things, you actually lose some freedom. Trading markets can be fun, but like a golf game, it may become an obsession.

STAGES OF MARKET ACTION

All speculative markets have the following basic movements:

1. Accumulation (congestion)—the bottom of a market.
2. Run up or thrust up.
3. Distribution (congestion)—the top of a market.
4. Run down or thrust down.

A fundamental understanding of these different stages of market action is critical if you are to be successful as a trader (Figure 1.1). About 85% of the time markets are in the congestion phase and you should trade for modest profits. Different phases of market action will be examined so that you will know the stage of the market, when to trade for quick profits during the congestion phase and when to hold on for the big run up or run down. First, examine the big picture and look for set-ups. This is normally done by studying the longer time frame bar charts. Next, fine tune your analysis by studying the shorter time frame charts for the final part of the picture. This will assist you in knowing where to enter the market, where to take profits, and most importantly, when to abandon ship when one is obviously on the wrong side of a

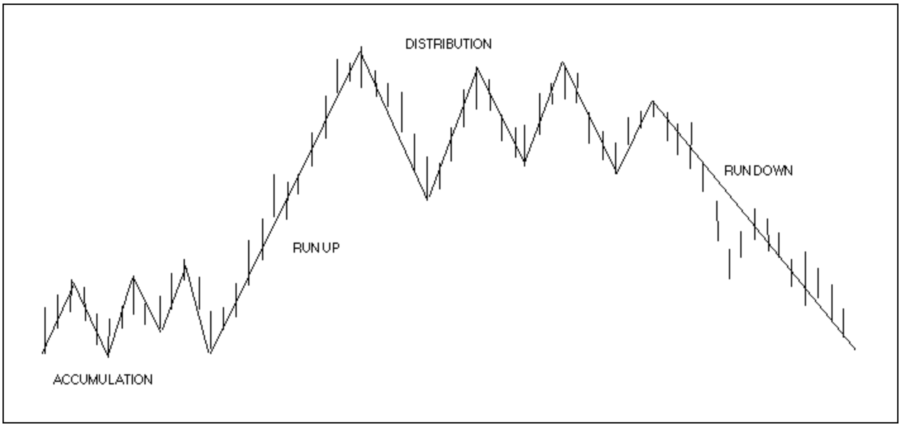

FIGURE 1.1 Four states of market action.

trade. By closely examining bar charts, you can see which direction the market is likely to take. Reading the news is generally dangerous. Read the charts instead and always think supply or demand or greed and fear. A chart reveals a number of things: When demand is greater than supply, the market goes up until the two are in balance. A chart also is an expression of greed and fear. Compare the two emotions and ask yourself which is the stronger one:

- *Greed:* "Gee, I wish I had bought more, this trade could have been worth a million bucks."
- *Fear:* "Oh brother, if this market goes down any more, I will lose everything I have."

Fear is a stronger emotion than greed and that is why markets fall faster than they go up.

Markets may enter reaccumulation and/or redistribution phases after a run up or run down. Newton's theory is at work here. A body in motion tends to remain in motion. Translated, a trend once started tends to continue with periodic periods of rest or digestion. The basic Wave Theory of 5 waves up or down (covered more extensively in Chapter 2), expands on this type of market action. That is the reason markets normally go out of a phase in the same direction as they entered. Until further evidence based on chart action suggests otherwise, you should trade in the direction of the market prior to its entry into congestion. Be alert for trend change after a second or third mark up/mark down in one direction.

These patterns may differ in specifics but repeat over and over again in all speculative markets. Some stocks remained locked in congestion for years. These are generally ones that simply have poor fundamentals. They are likely to remain there. Trade stocks that are moving.

Accumulation Set-Up

Phase 1 Selling Climax

The accumulation set up generally begins with a *selling climax* (Figure 1.2). This is the first sign of market selling exhaustion and the beginning of accumulation. A selling climax is characterized by several down bars of relatively wide ranges with the last bar having the biggest range with a big increase in volume.

A *sharp rally* follows the selling climax. This rally exceeds any previous rally in the prior down move in both time and distance. This is a requirement prior to the market entering into accumulation action. Unless you have this sharp rally, the question is still open regarding whether or not the downturn is over.

A *test of the low* after this sharp rally follows. This movement down may hold at a higher level or make a slightly lower bottom.

Phase 2 Zones of Support and Resistance

The market will now enter a stage where supply and demand are essentially equally balanced. Zones of support and resistance are established during this phase. A zone of support is in the range of the low bar of a selling climax or a subsequent low as shown in Figure 1.3. A zone of resistance is the exact opposite. If this is accumulation, volume will begin

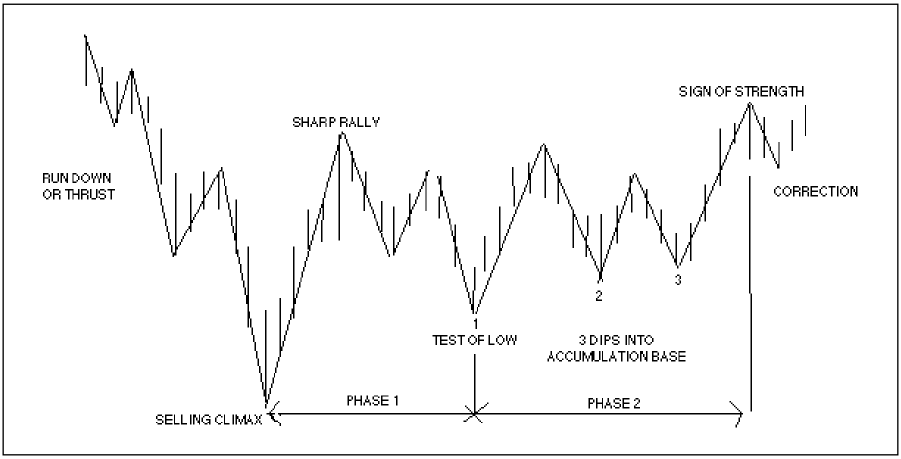

FIGURE 1.2 Accumulation stage.

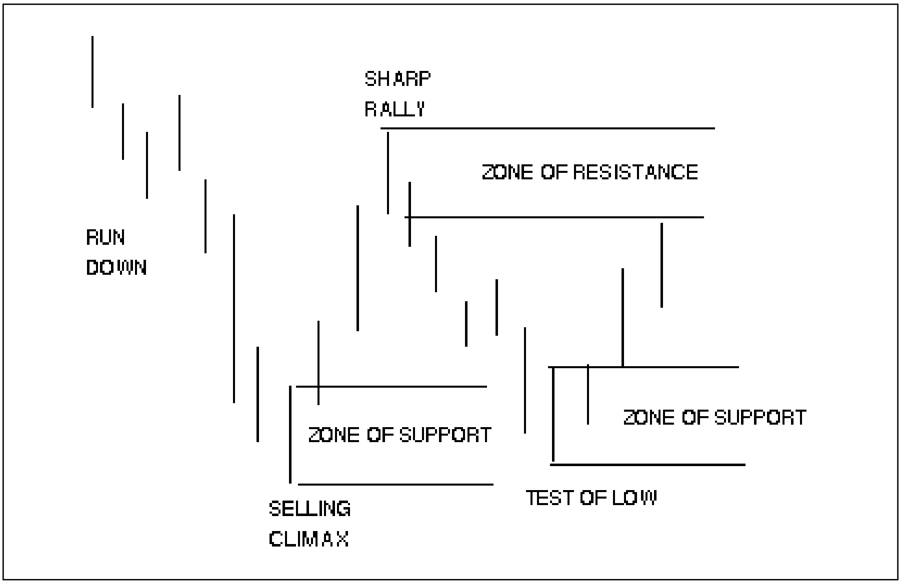

FIGURE 1.3 Zones of support and resistance.

to increase on the up days and be somewhat less on the down days. Toward the end of this phase, the market tops and bottoms may be higher than previous rallies and reactions.

Several attempts are made at new lows with significant rallies in between after the sharp rally. After two to three attempts to make new lows without success, be particularly alert for a wide range bar up. This type action indicates people are buying strongly each time the market approaches these lows. The third time signifies that the market has a high probability of a break out to the upside. A rallying tendency toward the end of the accumulation set-up is probable. A potential buying point is on the second or third dip into the accumulation zone.

A *sign of strength* occurs when the market exceeds one or two previous tops by a significant amount. A significant amount is defined as at least one average bar range above one or more previous tops. The magnitude of the top penetration of one or more prior market tops is indicative of accumulation set-up completion. A small penetration of prior tops with quick fall back implies some supply and a possible move back to the lower zone of support. Conversely, a significant penetration that has follow through implies demand. The market should hold above these prior tops for several bars for added confirmation. This indicates accumulation is over and the market may enter the run up phase.

After the sign of strength, markets generally move back to about the 50% correction point of the prior market swing. This is the beginning of the run up phase. Run up or run down is frequently referred to as *thrust*. Resist the urge to buy when the market is making new highs. Impulsive buyers who believe they will not be on board for the big move frequently do this. There are innumerable opportunities in other stocks that are in the accumulation phase in preparation for a breakout to the up side. Enter the market on your terms rather than chasing it. Chasing the markets and buying at tops often results in being stopped out when the market has its normal correction.

To summarize:

1. First rally after a selling climax rarely holds.
2. If any buys are made in the early accumulation set-up, small profit opportunities are likely until accumulation is complete.
3. The best profit opportunities are from buying toward the end of completion of the accumulation set-up.
4. The greatest profits are achieved during the run up and run down phases of the markets.

Take Profits

If the market is in obvious congestion, the profit-taking points are in the zone of resistance. Liquidation orders should be placed ahead of time as these zones are frequently entered and immediately drop away. The profit opportunity may quickly disappear if the liquidation order is not in the market. A bad trading habit is to wait and see how the market acts when it reaches the target or resistance zone. This may be done if the lower time frame is closely monitored.

Terminal Shakeout

A market may have a *terminal shakeout* at the end of the accumulation set-up (Figure 1.4). This is characterized by the market breaking below the entire range of accumulation with an increase volume. This is followed by an equally rapid recovery of the entire loss. It may then back off slightly, go dead and then take off with expanded volume and thrust. The terminal shakeout traps the crowd who sells new lows. These trades can quickly result in significant loss. This type action is also called a *V bottom*.

Distribution Set-Up

Phase 1 Buying Climax

The distribution set-up generally begins with a *buying climax* (Figure 1.5). This is the first sign of market buying exhaustion and the beginning

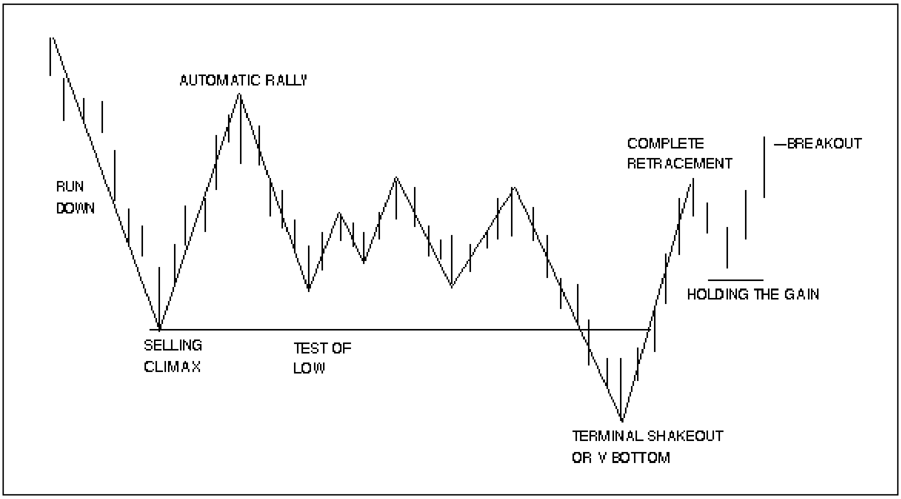

FIGURE 1.4 Terminal shakeout.

of distribution. A buying climax is characterized by several up bars of relatively wide ranges with the last bar having the biggest range with a big increase in volume.

A *sharp reaction* follows the buying climax. This reaction exceeds any previous reaction in the prior up move in both time and distance. This is a requirement prior to the market entering into distribution.

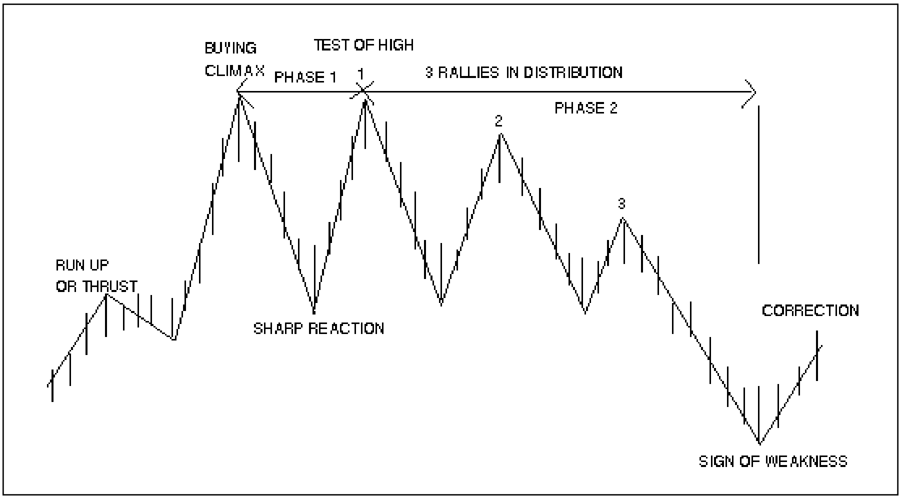

FIGURE 1.5 Distribution stage.

Unless you have this sharp reaction, the question is still open regarding whether or not the up move is over.

A *test of the high* after this sharp reaction follows. This movement up may hold at a lower level or make a slightly higher top.

Phase 2 Zones of Support and Resistance

The market will now enter a stage where supply and demand are essentially equally balanced. If this is distribution, the volume will begin to increase on the down bars and be somewhat less on the up bars. Toward the end of this phase, the tops and bottoms may be lower than previous rallies and reactions.

Several attempts are made at new highs with significant reactions after the sharp reaction. After two to three unsuccessful attempts to make new highs, be alert for a wide range bar down. This type action indicates aggressive selling each time the market approaches these highs. The third rally failure signifies that the market has a high probability of a break out to the downside. A potential selling point is on the second or third rally to the zone of resistance.

A *sign of weakness* occurs when the market falls below one or two previous bottoms by a significant amount. A significant amount is defined as at least one average bar range below two to three previous bottoms. The magnitude of penetration off one or more prior market bottoms is indicative of distribution set-up completion. A small penetration of prior bottoms followed by quick rallies implies demand and a possible move back to the higher resistance levels. Conversely, a significant penetration that follows through implies supply. Market should hold below these prior bottoms for several bars for added confirmation. This indicates the distribution stage is over and the market may enter the run down phase.

After the sign of weakness, markets generally move back to about the 50% correction point of the prior market swing. This is the beginning of the *run down phase*. You should resist the urge to buy when the market is making new lows. Impulsive sellers who believe they will not be on board for the big move frequently do this. There are innumerable opportunities in other stocks that are in the distribution phase in preparation for a breakout to the down side. Enter the market on your terms rather than chasing it. Chasing the markets and selling at bottoms often results in being stopped out when the market has its normal correction.

Summarizing:

1. The first reaction after a buying climax is generally followed by a significant rally. However, remember markets fall faster than they climb.

2. If any sells are made in the early distribution set-up, then small profits are likely until distribution is complete.
3. The best profit opportunities are selling toward the end of the accumulation set-up phase.
4. The greatest profits are achieved by trading the run up and run down phases of the markets.

Take Profits

If the market is in obvious distribution, the profit-taking points are in the zone of support. The zone of support is in the area around the prior bottoms of the congestion area. Liquidation orders should be placed ahead of time because these zones are frequently entered and immediately move away. If the liquidation order is not in the market, the profit opportunity may quickly disappear. A wait and see approach when markets enter the support zone has its hazards. Monitoring the lower time frame may be of assistance.

Reaccumulation

Trading the markets would be easy if you could assume that after a buying climax the market enters a distribution set-up and that the next move will be down. This is not reality. True, the market will enter congestion, but this area of congestion may be reaccumulation. A market may have a buying climax which signifies the run up is over. This does not mean that the market is going to go down. This is simply an area of digestion or resting while supply-and-demand forces decide whether the next move will be

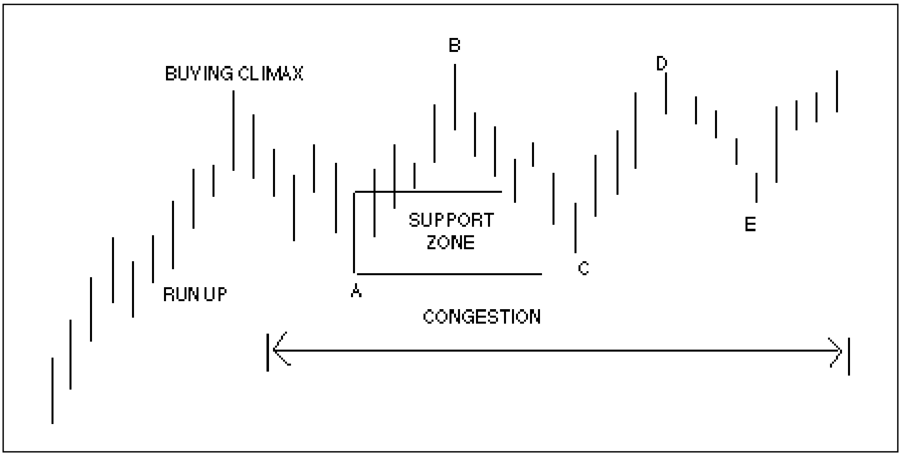

FIGURE 1.6 Reaccumulation.

up or down. Look for the market to have several rallies and reactions. After the second or third rally in this congestion, the range and location of the bars in the trading zone will frequently give an indication on direction of the next move. Markets generally move out of congestion in the same direction that they entered congestion. Figure 1.6 on page 17 shows a stock entering congestion after a buying climax. If you trade at all in this zone of congestion, buy dips and sell rallies until point E. Note that the lows are higher and the market is trading and holding for several bars near the top of the trading rage. This implies reaccumulation with another run up likely. The basic ideas are the same, only in reverse for redistribution.

Run Up and Run Down Stages

The *run up and run down* phases are the most profitable (Figure 1.7). However, these moves occur only about 15% of the time between the congestion zones. The parallel movement theory works extremely well in running markets. Fundamentally, this theory is that rallies and reactions will equal previous rallies and reactions. Buy on equal reaction points and take profits at equal movement rallies or thrusts. The run down phase is roughly the mirror image of the run up phase. Down markets generally fall quicker and deeper than up markets. Fear is a greater emotion than greed.

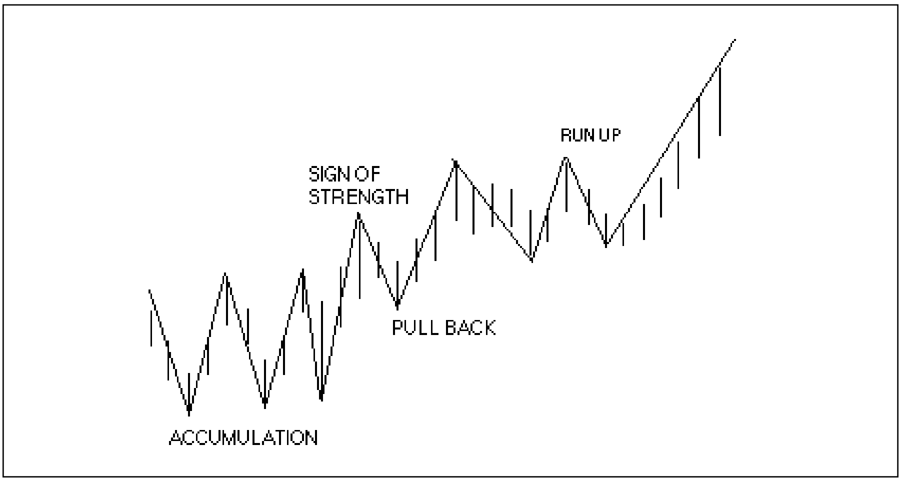

FIGURE 1.7 Run up stage.

Market Exhaustion

After an extended up move or even a move of three bars in one direction, the markets are often in their most vulnerable position and subject to a correction and may be the beginning of a new trend. A strong reversal bar at this point is the place to take a nibble on the short side. Get out of the position if the market fails to follow through in the next couple of days. A lower opening is the first sign of exhaustion and perhaps end of move.

Five ways to tell when an up market may be entering congestion:

1. Market has 2 wide-range bars down.
2. The market is unable to make a new high for 10 bars.
3. The market has non-overlapping days counter to the prevailing trend. A non-overlapping bar is when the high of a bar is less than the low of the top bar. This may occur three to four bars after the top bar.
4. The market has a sharp spring or upthrust after an extended run. A spring is when the market goes to a new low, finds no supply, then aggressively rallies. An upthrust is when the market goes to a new high, finds no demands, and falls rapidly. Chapter 6 discusses these concepts in more detail.
5. The market has a 75% retracement or greater of last thrust.

End of Move

The end of a price movement is signaled when the high price of a move cannot be exceeded by three attempts to breakthrough to new highs. This is usually preceded by shortening of the upward thrusts. This is presumptive evidence that the upward move is over either temporarily or permanently. This is a point to either take profits or move stops in tight.

HOW TO MAKE MONEY WITH THIS THEORY

The big question is how does one use the preceding information to make money in the markets. Before you are through with this book, this question will have some answers. The goal is for you to see and recognize the set-ups and patterns at the time they occur and not in hindsight. Anyone can see them after the fact. What follows is a method that might be used. Rules are given. Charts show patterns and places to use the rules for buy/sell entries.

Identify the congestion action as one of reaccumulation or redistribution by the direction of the last run up or run down. Markets generally

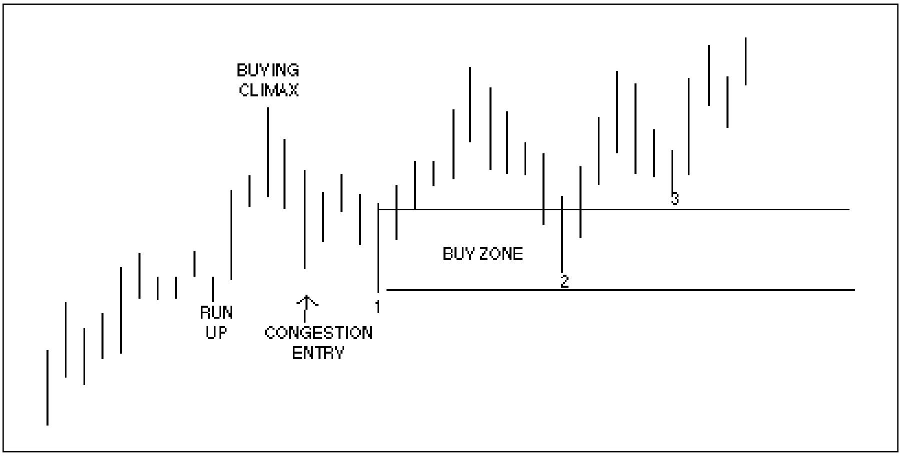

FIGURE 1.8 Reaccumulation.

go out of congestion in the same direction from which they entered. Assume this to be the case until the congestion pattern suggests otherwise.

Figure 1.8 shows a stock in reaccumulation. Buy zones (Figure 1.9) may be defined as follows (sell zones are the opposite):

- At or below a 50% correction of the run up, or
- In the support zone.

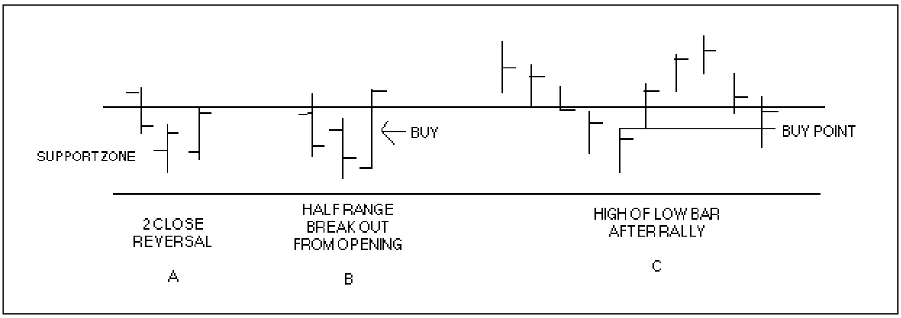

FIGURE 1.9 Buy entry patterns.

Long entry is made once the market enters the support zone by using the following rules:

- Closing above two or more prior closes with a wide range bar and expansion of volume. A wide range bar is one that is greater than the 10-day average range of the bars.
- Buy on a half range breakout from the opening. Compute 50% of the prior days range and add that to the opening.
- Buy on the second or third pullback to the support zone. Beware of doing this on the fourth pullback as markets usually break through on the fourth testing of an area.
- A close on day of entry above the prior day's high and opening is further confirmation of strength.
- A market unable to make a new high for 10 bars raises a red flag.
- Buy after a two to three bar movements into the support zone. You must be alert and have the ability to act quickly or the opportunity will be missed on the good trades. The bad trades will give you plenty of time to act. The time window for good trades is frequently very narrow.

Stop

Two stop points are suggested: An average range below the prior reaction point low, or an entry bar range below the low of entry bar. This stop is moved up as soon as some breathing room develops. Liquidate the position if market does not respond within about three bars. Do not wait for the stop to be hit.

Target

The target or profit objective shown in Figure 1.10 is:

- *Box target.* The width of the box of the accumulation pattern (B = A), or
- *Swing target.* 50% of the run-up movement or thrust added to the high of the move for first objective or 100% for second objective.

Once the market reaches the target zone, either liquidate at market or on evidence that supply is overcoming demand.

These targets will be used throughout this book. If in a position and the market enters the objective area, you should be alert to either take profits or at least tighten the stops.

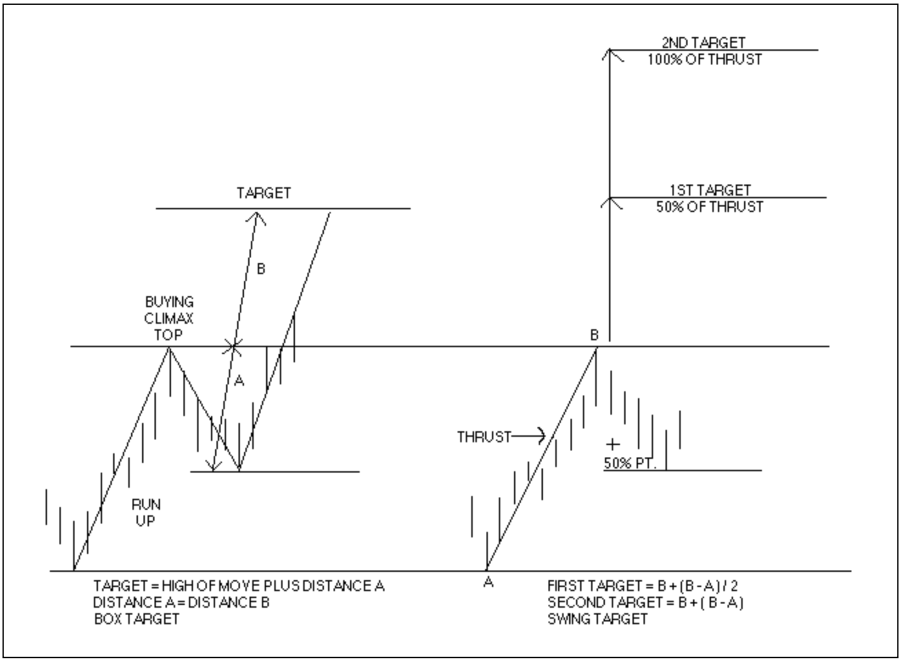

FIGURE 1.10 Targets for moves.

CASE STUDY OF TRADING RULES

Figure 1.11 is a chart of General Motors demonstrating the use of these rules for trading during a 12-month period (July 1998–July 1999). General Motors went from 61 down to 39, up to 78, and back down to 62. Buying and holding the stock would have produced a 5 point profit. Trading by the techniques, as outlined above, yielded a profit of around 30 to 45 points. Marked on Figure 1.11 are the principles used. Five trades were made during this time (Figure 1.12).

Trade One

The thrust that penetrated the support point at 58 turned the trend down. Congestion is forecast with an eventual breakout to the downside. Two rallies were made in this zone. A short position was taken at 60 on the second rally upon the appearance of the outside day (a day where the high and low is outside the range of the prior day). Initial stop was one entry day range day above the high of entry day. Profits were taken at the target of around 48 for a profit of about 12 points.

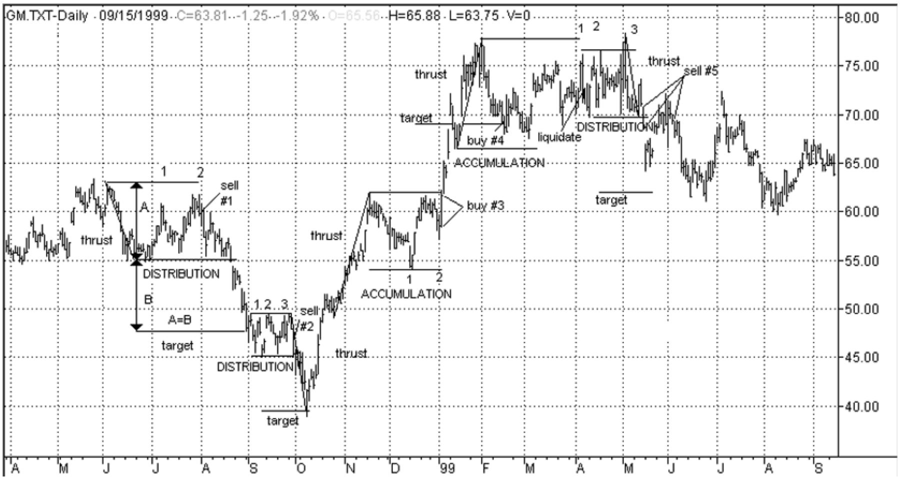

FIGURE 1.11 GM.TXT-Daily (September 15, 1999). Created with TradeStation 2000i by Omega Research © 1999.

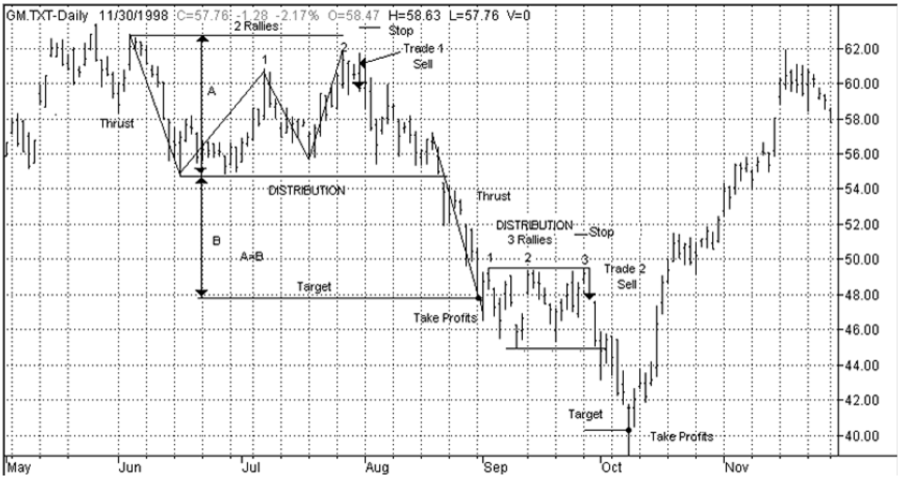

FIGURE 1.12 GM.TXT-Daily (November 30, 1998). Created with TradeStation 2000i by Omega Research © 1999.

Trade Two

The market had three rallies in this second zone of congestion. Short was taken on the wide range down bar after the third rally at 48. Profits were taken at the target for a profit of about 7.5 points. A wide range down bar is one where the range is greater than the average range and market closes below the opening and prior close.

Trade Three

Congestion did not take place again until the market reached 62 (Figure 1.13). A buy was made at either the 50% point of the correction or on the wide bar up from the 50% point. Profit taken at target of 9 to 13 points.

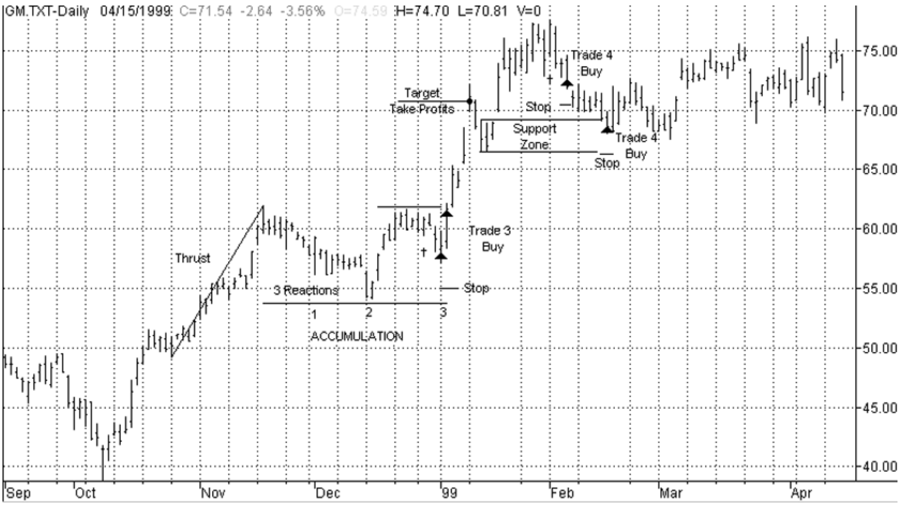

FIGURE 1.13 GM.TXT-Daily (April 15, 1999). Created with TradeStation 2000i by Omega Research © 1999.

Trade Four

This trade (Figure 1.14) was a loser if purchased at the 50% point of the run up. However, if bought at the high of the low bar of the prior thrust, it yielded a small profit. The position was liquidated when it was noted that the wide range down bar implied distribution and not accumulation. The profit at most was 4 points, loss may have been 3 points with a one range stop from point of entry.

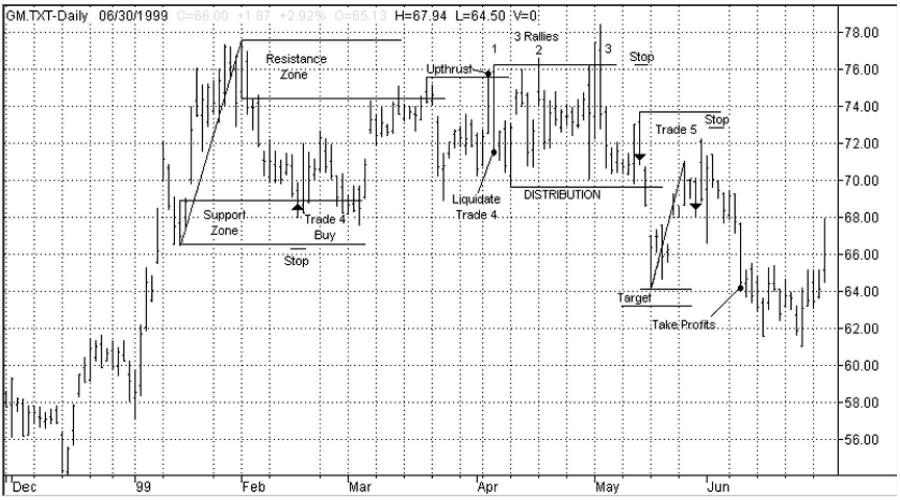

FIGURE 1.14 GM.TXT-Daily (June 30, 1999). Created with TradeStation 2000i by Omega Research © 1999.

Trade Five

The up thrust on the third rally with subsequent movement to the low of the range clearly defined this area as distribution. A short was made on one of the two pull backs. Note that short was made on a pullback or rally. The trade was liquidated at the 64 area for a profit of 5 to 7 points.

TO TRADE OR NOT TO TRADE

Your money is not at risk when it is not in the market. This style of trading limits exposure to around 10% to 15% of the time. You will be out of the market 85% to 90% of the time. A position may be held through an accumulation/distribution period. There is nothing wrong with this approach. However, by so doing, the potential exists for giving back a substantial amount of the profits. The pattern may be distribution rather than reaccumulation. You must examine many charts to prove to your satisfaction that this is a valid approach and is suitable to your style and comfort level of trading.

This approach involves some judgment. You should attempt to mechanize as many rules as possible to keep the judgment down to a minimum.

Trade the Markets That Are Moving

For active trading, you should look for stocks and/or futures that are moving or trending and not dull sideways moving equities. The definition of a moving equity is somewhat subjective. There are many sources that rank stocks that are out performing others and are moving. *Investors Business Daily* is a great source for finding stocks that are moving.

Moving equities might be vehicles that:

- Have expanded volatility.
- Have made new four-week highs.
- Stocks that are in the run up phase
- Slope of a 20-day moving average of closes is decidedly up/down.
- The leaders in their particular sector of the market.

CONCLUSION

Remember, the name of the game is to be profitable, not to catch 90% of every move. Learn to be satisfied with small chunks of the market. Enter the market on pattern set-ups and take profits at targets or at the first sign of supply overcoming demand.

These same principles work in any time frame, including day trading. There is something here for every time-frame trader. If your perspective is longer term, go to the weekly charts. Many false moves will be made, but that is what stops are for. The only way you will make money with trading is to look at numerous charts and mark your buy/sell, take profits, and stop loss points on them. This makes the idea yours rather than ours. You might then be successful in your trading. One of the most difficult things you will ever do is liquidate a position toward the end of the run up phase or at a buying climax. Develop the attitude of being a nice person: When everyone is wanting to buy, sell them some.

The General Motors study is only an example of how you build a trading system based on the supply/demand forces of the market. Mark up many charts with the things you see relating to supply/demand or buying and selling climaxes. Read *Popular Delusions and the Madness of Crowds* by Charles Mackay. Written 160 years ago, the principles are just as true today as in 1841. Don't trust your memory. Keep a log book on your trading activities. Write down what you see every day and frequently review your notes. Keep two charts: One on what you did, another one on what should have been done. Learn by comparing. Show the principles occurring at market turning points. Hindsight analysis is usually at least 90% correct. The goal is to see the patterns as they are taking place and take appropriate action.

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NOTE

Some of the ideas regarding supply and demand are based on the pioneering studies of Wyckoff, Tubbs, and Larsen. Further studies by Wyckoff are available from the Stock Market Institute in Phoenix, Arizona and *Stocks and Commodities Magazine*. The Tubbs and Larsen courses came from a private collection.